Chapter IX

Additional Savings Possibilities

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Introduction

In this audit area, we reviewed the Company's preliminary estimates of merger savings and compared these estimates to those of the Merger Integration Teams (MIT). In addition, we reviewed the MIT Plans to ensure that the Company adequately considered all potential savings areas and reviewed the merger team initiatives that are considered out of scope by the Company. The purpose of this review is to ensure that all potential savings areas with implications for Illinois have been identified and are included in the Company's net savings calculations.

Original SBC Savings Estimates

In its proxy statement relating to the merger SBC estimated that the merger would provide $2.5 billion of annual pre-tax benefits for the combined companies.

The companies described the potential for synergies, including expense savings, revenue increases and capital investment reductions, as one of the principal reasons for the SBC/Ameritech merger. The SBC/Ameritech Merger Proxy Statement reads as follows:

> The SBC Board and SBC management believe that the Merger will result in significant opportunities for cost savings, revenue growth, technological development and other synergistic benefits. Economies of scope and scale, the elimination of duplicative expenditures and the consistent use of the best practices of SBC, Ameritech and SNET in cost control and product offerings are expected to enable the combined company to realize significant cost savings and revenue enhancements. SBC estimates that these potential synergies could be achieved by the third full year following consummation of the Merger. The estimated pre-tax synergies are expected to be derived from $1.2 billion in potential expense savings, including expense savings resulting from elimination of redundant administrative functions, increased scale and the adoption of 'best practices'; $750 million in potential additional revenues synergies, including revenue enhancements resulting from increased use of residential vertical features, additional residential telephone lines, increased caller ID penetration, and increased use of the directory business; and $300 million in potential combined future long distance synergies. Additionally, the Merger also provides the opportunity to reduce capital expenditures by $250 million annually in three years, including through procurement savings.

Ameritech's Board supported the merger based upon its belief that SBC could attain substantial savings for the merged entity, as follows:

> The Ameritech Board considered the opportunity presented by the Merger for two well-regarded, profitable companies to integrate and apply as best

> practices, marketing programs and product offerings. The Ameritech Board also considered management's view that the Merger would create opportunities for elimination of duplicative expenditures, joint technological development and other synergistic benefits in which Ameritech shareowners would be able to participate as shareowners of SBC following the Merger. The Ameritech Board concluded that the cost and operating synergies expected to be achievable as a result of the Merger would not be available to Ameritech on its own. In addition, the Ameritech Board considered the demonstrated ability of SBC's management to successfully integrate and obtain synergistic benefits from previous SBC acquisitions, most notably SBC's acquisition of Pacific Telesis Group.

Goldman Sachs performed an analysis of the synergies estimated by the management of Ameritech to be achievable following the merger. Goldman Sachs assumed that 40 percent of the projected annual cost synergies would be generated in 1999, 70 percent in 2000, 90 percent in 2001, and 100 percent in 2002. Their analysis showed a range of incremental annual pre-tax earnings of $1.8 billion to $2.7 billion. For purposes of the Pro Forma Merger Analysis and the Present Value of Future Performance Analysis, Goldman Sachs used anticipated synergies of $2.3 billion, which constituted the mid-point of the range of incremental pre-tax earnings. The $2.3 billion figure is within ten percent of the $2.5 billion estimate made by SBC.

A May 1998 assessment by Credit Suisse/First Boston Corporation (Credit Suisse), an investment firm not involved with the SBC/Ameritech merger, indicated that they agreed with SBC that its $2.5 billion synergy estimates were conservative. Having observed the successful integration of SBC with Pacific Telesis Group (PTG), and reporting about a year after the completion of that merger, Credit Suisse noted that the projected Year 2000 run rate synergies exceeded the $1.1 billion in the original plan by $900 million, including $400 million attributable to expense and capital savings. Credit Suisse indicated its confidence in management's ability to drive the benefits of the SBC/Ameritech merger to the bottom line. However, it also noted that the expense synergy estimate for the SBC/Ameritech merger was only about one-half the synergy amount SBC expected to realize from the PTG merger. This is consistent with the Company's assertion that fewer avenues for achieving savings are available in the SBC/Ameritech merger because of the synergies produced in the SBC/PTG merger.

In their Joint Applicants' Response to the ICC's June 4, 1999 List of Issues and Joint Applicants' Additional Commitments from the ICC SBC/Ameritech merger proceedings, SBC and Ameritech addressed the potential synergies as follows:

> During due diligence, SBC prepared an estimate of annual recurring cost savings, and the one-time, non-recurring investment necessary to achieve those savings, that could result from the merger of SBC and Ameritech. These estimates were based upon the understanding of Ameritech and SBC operations and a general understanding of the business. Estimates were based on available data, some of which was derived directly from FCC ARMIS Reports, experience gained in Pacific Bell's re-engineering efforts prior to the

SBC/PTG merger, and significant experience gained in planning for and ultimately implementing the integration of SBC and PTG.

The SBC synergy projections in the Proxy Statement and the Joint Applicants' Response to the Commission's June 4 list of Issues and Joint Applicants' Additional Commitments were based on the work of Mr. Martin A. Kaplan, who, at the time of the analysis of the potential merger synergies, was an Executive Vice President of PTG. He was previously the manager of the PTG re-engineering effort and the SBC/PTG merger integration process. Mr. Kaplan later supervised the SBC/Ameritech post-merger benchmarking process, the target setting for the MITs, the work of the MITs, and the approval of their plans.

Mr. Kaplan developed his projections during the period in which discussions were being held between SBC and Ameritech regarding a potential merger. His projections were based upon his experience in the Pacific Bell re-engineering project, the SBC/PTG merger, and his analysis of available Ameritech information. The results of his analysis are summarized in an affidavit dated July 20, 1998 filed with the FCC and referred to by Mr. James S. Kahan, Senior Vice President for Corporate Development of SBC Communications, in his testimony before the ICC during the merger hearing.

In his affidavit, Mr. Kaplan projects that, overall, "the SBC/Ameritech merger will create opportunities for revenue growth and cost savings estimated to have a value of approximately $2.5 billion by 2003." The $2.5 billion is the same amount used by SBC in its Proxy Statement. Mr. Kaplan projected that increased revenues of $778 million by 2003 would come from increased sales of vertical features, additional lines, directory advertising, data services, wireless services, Centrex and other services, and not from price increases.

Regarding cost savings, Mr. Kaplan estimated annual recurring cost savings of $1.43 billion across the companies, including $1.17 billion in expense savings and $0.26 billion in capital savings. A breakdown of savings by business function is shown in Exhibit ASP-1:

Exhibit ASP-1
SBC Original Merger Savings Estimate
(Dollars in Millions)

Area	Annual Savings
Telephone Company Operations	$313
Administration	201
Support Functions	771
Other Business	146
Total	$1,431

Source: Affidavit of Martin A. Kaplan, July 20, 1998.

Following the merger, Mr. Kaplan supervised the SBC/Ameritech merger implementation benchmarking and target setting process.

(redacted)

Investigation of Other Potential Savings

The MITs have focused their efforts on revenue enhancements, labor and contract services savings (primarily for expense accounts) and material cost reductions (both for expense and capital accounts). The teams addressed telephone company operations, shared services, and headquarters functions. With respect to the Illinois Bell income statement, the MITs addressed the revenue accounts, and certain of the expense accounts, namely: Plant Specific Operations, Plant Nonspecific Operations, Customer Operations, and Corporate Operations.

In planning the audit, BWG identified six areas of potential cost savings that we thought the MITs might not have considered:

- Pension Expense
- Audit Fees
- Insurance Costs
- Depreciation
- Taxes
- Interest

We focused on pension expense because MIT 29 had not completed its initial work on employee benefits. Since then, MIT 29 has completed its planning work and pension expense is included within its scope. While the team has made no pension expense savings estimates, BWG believes that there are potential savings from settlement gains related to lump sum payments from the pension plan to employees whose termination is merger related. Further, changes in actuarial assumptions adopted by Ameritech as of July 1, 1999 are merger related and produced savings that were not captured by the merger teams.[xx] Although the Company disagrees, these matters have been addressed to conclusion in this audit by a benefits expert engaged by BWG as a sub-consultant at the request of the Commission. Further discussion and analysis of these potential savings opportunities is included later in this chapter of the report.

[xx] BWG's position is supported in the Merger Order at page 47: "... the term 'savings' refers to an actual reduction in costs or expenses."

Exhibit ASP-2
Reconciliation of Kaplan and MIT Projected Savings
(Dollars in Millions)

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Audit fees were identified as another potential area of undocumented savings. However, MIT 26, Finance, covered this topic and identified annual savings of (redacted) in this area. These savings are included in the MIT 26 totals and will be reported by the Company in the normal MIT savings tracking process.

Similarly, insurance costs were included in the scope of MIT 26, Finance, and (redacted) of insurance cost savings for Illinois was reported in the SBC/Ameritech 1999 Merger Cost and Savings Report filed with the Commission on April 10, 2000. Further, as of February 2000, the MIT effort had identified an additional (redacted) in insurance-related merger cost savings. The actual savings will be tracked and reported by the Company in the normal MIT savings tracking process.

As part of the MIT process, depreciation expense savings will be determined based upon capital cost savings and implementation capital when these amounts are known. The database used for the development of the MIT plans requires the input of the estimated useful lives of capital assets. Although no depreciation expense effects have been determined to date, the Company has stated that depreciation expense savings will be calculated for inclusion in the Year 2000 Report before the report is filed with the Commission in 2001. BWG provides a rough approximation of a depreciation expense savings benchmark later in this chapter of the report.

Although not included in the benchmarking process, the MIT 26 Finance team also considered possible taxes and interest expense savings. Even though the team identified no opportunities to reduce these expenses, BWG believes there are potential savings opportunities and provides its analysis of these expense categories later in this chapter of the report.

Pension Expense

At the date of the merger, the Company maintained two pension plans. The Ameritech Pension Plan (APP) covers bargaining unit employees and the Ameritech Management Pension Plan (AMPP) covers non-bargained employees. During the year ended December 31, 1999, lump-sum payments were made to employees who terminated their employment in the amount of $462.9 million from the AMPP and $601.0 million from the APP. The Company determined the related Settlement and Curtailment impacts of these payments as shown in Exhibit ASP-3 below:

Exhibit ASP-3
Ameritech Pension Plans Settlement and Curtailment Impacts
Year Ended December 31, 1999 Under FAS 88
(Dollars in Thousands)

	AMPP	APP	Total
Settlement Impact - Gains due to threshold being met	$332,076	$260,833	$592,909
Curtailment Impact			
AMPP Pension Gain	1,583		1,583
Management Retiree Medical/Life Curtailment (Loss)	(27,801)		(27,801)
Total FAS 88 net Gain	$305,858	$260,833	$566,691

Source: SBC Analysis of Settlement Gains related to AMPP and APP Lump Sum Payments(Document Request JDH 11.1)

Statement of Financial Accounting Standards No. 88 (FAS 88) entitled *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* governs the accounting for settlement gains and specifies the manner in which they are to be calculated. A synopsis of this accounting standard and others that pertain to our analysis of the Company's pension expense follows:

FAS 87 – Employers' Accounting for Pensions. FAS 87 was adopted by the Financial Accounting Standards Board (FASB) in December 1985. This Statement supersedes previous standards for employers' accounting for defined benefit pension plans, and requires that a standardized method be used for measuring the annual pension expense (Net Periodic Pension Cost) and provides for expanded financial statement disclosures. The components that determine the Net Periodic Pension Cost are as follows:

Service Cost: The annual cost of retirement benefits accrued during the fiscal year.

Interest Cost: The increase in the Pension Benefit Obligation (PBO) due to the passage of time. The PBO is the present value of future benefits earned based on future compensation levels and accrued service.

Expected Return On Plan Assets: Recognition of the effects of changes in the fair value of plan assets. In addition, certain items are not required to be recognized immediately, but must be amortized over the expected working lifetime of the employee population. These amounts are as follows:

- Prior Service Cost: Change in the PBO due to plan amendments that occurred in the current or prior fiscal years.
- Net Obligation/(Asset) existing at January 1, 1987: The funded status of the plan (PBO minus Assets) at the time the FAS was first adopted.
- Net Gain or (Loss): The difference between the expected and actual plan experience.

The determination of the Net Periodic Pension Cost may also include curtailment and settlement gains or losses, if certain events or transactions have occurred. The accounting standards for these events or transactions are addressed in FAS 88, which is summarized below.

FAS 88 – Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits. FAS 88 was also adopted by the FASB in December 1985. It is closely related to FAS 87 and is intended to be considered in that context. This Statement requires immediate recognition of certain previously unrecognized amounts when certain transactions or events occur and prescribes the method for determining the amount to be recognized in earnings when a pension obligation is settled or a plan is curtailed.

Under FAS 88, a curtailment occurs if a significant amount of *future* benefits have been curtailed, for example, the plan freezes future accruals, or a significant number of plan participants leave the company. When this occurs, the PBO for these participants is determined without regard to any salary increase, hence, the PBO now becomes the Accumulated Benefit Obligation (ABO). Under the rules of FAS 88 an increase or decrease in PBO due to a curtailment is first used to offset any accumulated actuarial gains or losses and is not recognized in pension expense. FAS 88 also requires the accelerated recognition of prior service costs that were accumulated in prior years.

A settlement occurs if a significant amount of ABO has been extinguished through the distribution of lump sum payments, or annuity purchases in a non-participating contract. In order for a settlement to occur, the amount of ABO extinguished for the fiscal year must be in excess of the sum of the Service Cost and Interest Cost components of the Net Periodic Pension Cost (the annual expense under FAS 87). In the event of a settlement gain, the recognition of actuarial gains that were accumulated in prior years must be accelerated. This results in a reduction in annual expense for the fiscal year that the settlement occurred. The intuitive reason behind the acceleration of the recognition of the accumulated gains is that a significant amount of the liability and assets associated with the benefits provided under the plan has been settled through termination of employment. Therefore, some of these accumulated gains must be recognized immediately rather than be amortized over future years.

FAS 106 – Employers' Accounting for Postretirement Benefits Other Than Pensions. This Statement was issued in December 1990. Although it applies to all forms of postretirement benefits, it focuses primarily on postretirement health care benefits. It significantly changed the practice of accounting for postretirement benefits on a pay-as-you-go basis by requiring that costs be accrued during the years that the employee renders service.

FAS 132 – Employers' Disclosures about Pensions and Other Postretirement Benefits. This Statement was issued in February 1998 as an amendment to FAS 87, FAS 88, and FAS 106. It modifies disclosure requirements but does not change the measurement or recognition of benefit obligations. FAS 132 requires disclosure of the settlement or curtailment gain as a component of the net periodic pension cost.

Pension Cost Reductions

In December 1999, Ameritech Illinois (AI) recorded a $119.9 million credit to pension expense for settlement gains resulting from the payment of lump-sum distributions to terminated employees. This represents about 21 percent of the $566.7 million in total net settlement gains recorded by Ameritech and shown in Exhibit ASP-3 above. In response to a document request, the Company stated that total lump-sum payments by Ameritech during 1999 were $462.9 million for the AMPP and $601.0 million for the APP. Of these amounts, the Company has determined that $10.3 million in AMPP payments were related to terminations directly attributable to the merger. The Company has also stated that it would be impossible to identify those employees who may have retired as an indirect result of the merger.

In response to a document request, the Company asserts that the reductions in pension expense recorded in 1999 and continuing in 2000 are not merger related:

> Pension settlement gains are not appropriate to consider in the calculation of merger related savings. The gains recognized are not current period gains. Nor were they caused in any way by the merger of SBC and Ameritech. Rather, they represent an accelerated recognition of gains that occurred in previous periods but were deferred in accordance with FAS 87 accounting rules. Merger-related activity did not create these gains or savings. It merely accelerated recognition of the gains.

FAS 87 requires the use of various assumptions. The most significant is the assumed discount rate, which is the interest rate that is used to determine the present value of future benefits. The discount rate reflects the rates at which pension benefits could be effectively settled at each measurement date. It is used to calculate the PBO and Service Cost. As of January 1, 1999, the discount rate for the Ameritech plans was 6.75 percent. Due to the merger, there was a remeasurement of the Reconciliation of Funded Status at as of July 1, 1999 and the discount rate was changed to 7 percent. An increase in the discount rate will cause a decrease in plan liabilities. It appears as though the Company used a discount rate of 6.75 percent for the first half of the fiscal year and a discount rate of 7 percent for the second half of the year in the determination of its 1999 annual pension expense.

USI Analysis

At the request of the Commission, BWG engaged the USI Consulting Group to assist in the analysis of merger related pension issues. USI is a firm of Benefit Consultants and Actuaries that specializes in Employee Benefits. USI was asked to address the following questions:

- Did the Company use a reasonable method of determining the employees who terminated employment as a result of the merger? Might other reasonable methods produce a different result?

- Are the settlement and curtailment gains and losses recorded by the Company during the year ended December 31, 1999 attributable to the merger? If so, what is the net amount of the merger related settlement and curtailment gains?

- Which of the changes to the Ameritech pension plans made as of July 1, 1999 had a significant impact on pension expense? What is the estimated amount of the reduction in pension expense attributable to each of the significant factors?

USI performed the following analytical procedures in connection with this assignment:

- Reviewed pension plan documents and other information to determine if there were any merger related changes in pension plan provisions that have an effect on pension expense.

- Reviewed actuarial valuation reports for the Ameritech Plans prepared in connection with FASB accounting and ERISA requirements.

- Reviewed actuarial valuation reports for the combined SBC Plans prepared in connection with FASB accounting and ERISA requirements.

- Reviewed actuarial assumptions adopted by Ameritech in anticipation of the merger to determine if there were any changes that have an effect on pension expense.

- Reviewed the Company's calculations of net settlement and curtailment gains reported in total for the year ended December 31, 1999, and the basis for the Company's determination of the amounts it considers merger related.

- Considered how other merger related activities may have affected current or future pension plan expense levels, or accrued expenses at the date of the merger.

Audit Objectives

- Identify and quantify potential net merger savings not covered by the MITs.

- Determine that there are no potential merger related saving included in the MIT initiatives that SBC considers to be out-of-scope that should be shared with ratepayers in Illinois.

Evaluative Criteria

- Are there any significant potential net merger savings not covered by the MITs?

- Does the Company have appropriate procedures in place to capture other potential net savings and credit them to the Illinois ratepayer?

Summary of Audit Procedures

- Reviewed the SBC pre- and post-merger analyses and merger hearing testimony to identify expected net savings.

- Reconciled the expected net savings with the MIT's targets.

- Evaluated the overall scope of the merger integration process and the coverage provided by the MITs.

- Reviewed the scope and work of each of the approximately 35 MITs considered in scope by SBC to discover any relevant potential net savings not identified by the MITs.

- Reviewed the scope and work of each of the approximately 15 MITs considered out of scope by SBC to identify any potential net savings that might be of interest to the Commission.

- Interviewed appropriate SBC personnel to explore areas of other potential savings and to examine the rationale for the Company's exclusion of initiatives from the scope of the audit.

- Requested relevant documents and analyses necessary to study other potential savings opportunities and the nature of the out-of-scope teams.

- Compared Ameritech Illinois' operating expenses for the 1st Quarter 1999 and 1st Quarter 2000 to determine if the Illinois financial results disclosed any additional merger savings opportunities not reported by the MITs.

Findings and Conclusions

1. Although the MIT process is designed to address cost and savings relating to depreciation expense, quantification has not yet been completed by the Company.

- Reduced capital investment resulting from procurement economies of scale and MIT initiatives that reduce or defer capital projects will reduce future depreciation charges.

- Likewise, capital expenditures needed to effectively implement the MIT savings initiatives will increase future depreciation charges.

- As shown in Exhibit ASP-4 below, BWG can provide a rough estimate of merger related depreciation expense savings that might be used as a benchmark for testing the amount of depreciation expense savings to be reported by the Company in its Year 2000 savings report. The amount in the exhibit is before Illinois allocation.

Exhibit ASP-4
BWG Depreciation Expense Savings Estimate
(Dollars in Millions)

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Projected Capital Expenditures Savings from Exhibit ASP-2	Amount
Purchasing	(redacted)
Information Technology	(redacted)
Real Estate	(redacted)
Support	(redacted)
Provisioning and Maintenance	(redacted)
Switching and Engineering	(redacted)
Total Capital Savings	(redacted)
Less Implementation Capital Expenditures	(redacted)
Net Capital Savings	(redacted)
Composite Depreciation Rate (SBC 1999 Annual Report)	7.4%
Estimated Annual Depreciation Expense Savings	(redacted)

Source: BWG Analysis.

2. Although the Finance Team 26 and SBC's tax management team reviewed opportunities for merger related tax savings, none have been determined.

- In 1978, Illinois replaced the real property tax applicable to Ameritech with an invested capital tax. However, the invested capital tax was repealed in 1998 and there are currently no local or state taxes related to property or capital investment.

- In connection with its pre-merger due diligence, the Company identified an estimated (redacted) in potential savings relating to Illinois state income tax expense. This amount is not included in savings being reported by the merger teams and should be considered merger related savings when the actual amounts are realized.

3. While it is likely the merger will result in improved cash flow and a commensurate reduction in interest expense, SBC has yet to identify any merger related interest savings.

    - The Company has taken the position that the interest expense savings driven by the positive cash flow effects of all of its cost savings initiatives are not subject to sharing because to do so would effectively cause SBC to share more than 50 percent of the merger savings.

    - As to expense savings, we agree. As savings flow to ratepayers, the Company will not have the benefit of improved cash flow related to one-half of the total savings.

    - However, we believe that the benefits of improved cash flow related to reduced capital expenditures should be shared with the ratepayers. Otherwise, there will be no sharing because cash flow savings will be credited to plant and equipment accounts.

    - As a rough approximation, the savings related to the improved cash flow from reduced capital expenditures can be computed using the estimated capital expenditures savings amount of (redacted) shown in Exhibit ASP-2 and the overall cost of capital amount of 9.4 percent from the 1994 Alt. Reg. Proceeding to produce an annual estimate of (redacted). Again, this amount is before Illinois allocation and should be reduced by the effects of implementation capital. Further, it should be reduced annually thereafter for the effects of accumulated depreciation.

    - Further, we believe that it is appropriate for the Commission to consider whether or not interest expense savings relating to revenue enhancement initiatives should be shared with ratepayers in Illinois.

        ⇒ Our analysis of MIT initiatives the Company considers out of scope shows several revenue enhancement initiatives within the regulated telephone operating companies that will produce improved cash flow when plans are developed and implemented.

        ⇒ Although the Company has taken the position that interest expense reductions related to improved cash flow from revenue initiatives are out of scope because revenues are out of scope, we do not agree. The merger order contains no reference to the treatment of interest expense savings, and this is something that the Commission will need to decide.

4. The Company has made an appropriate initial determination of the out of scope merger teams.

    - As shown in Exhibit ASP-5, SBC considers fifteen merger teams to be outside the scope of the audit and not subject to the sharing of merger-related savings with ratepayers in Illinois.

- Although teams 48 – Global Accounts, 50 – Business Revenue and 51- Consumer Revenue are within the regulated AI enterprise, these teams developed no merger savings initiatives and do not require further review.

- Team 53 – Industry Markets Revenue is also within the AI regulated enterprise and has developed plans for revenue enhancement only. This team will remain out of scope so long as its savings are entirely revenue related.

Exhibit ASP-5
Analysis of MITs Considered Out-of-Scope by SBC
(Dollars in Millions)

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Exhibit ASP-5
Analysis of MITs Considered Out-of-Scope by SBC
(Dollars in Millions)

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5. The Company has identified merger related employee terminations in a manner that may understate the amount of merger related pension plan settlement gains.

   - In response to a document request, the Company calculated settlement gains applicable to employees whose termination was merger related using the ratio of lump sum distributions paid to these employees to the total amount of lump sum payments made to all terminated employees.

   - Although it would be possible to compute the FAS 88 settlement gains separately for the lump-sum payments that are merger and non-merger related, the method described above is reasonable and would be a typical method used to capture the settlement gains related to a merger.

   - BWG tested the Company's list of employees whose termination is considered by the Company to be directly related to the merger by comparing the list to a list of employees who received merger related severance payments. With one exception, there were no employees receiving merger related severance payments who were not included on the list of merger related lump sum pension payments.

- The Company has stated that approximately two-thirds of the employee terminations occurring during 1999 occurred prior to the date of the merger and that no terminations prior to this date are considered merger related.

- Of the approximately 363 terminations during 1999 that are considered by the Company to be merger related, 39 were paid lump sums during 1999, 185 were paid lump sums in 2000, and 139 have received no payments from the pension plans to date.

- The Company has stated that it would be impossible to determine whether or not an employee's termination during 1999 may have been indirectly related to the merger. However, although outside the scope of this audit, a review of the transcripts of exit interviews or other information contained in personnel files would likely result in the identification of additional employees who terminated their employment because of the uncertainty of their employment status following the merger.

- Further, as shown in Exhibit ASP-6 below, there is at least anecdotal evidence that the merger contributed to an increase in employee terminations in 1999 and contributed to an increase in pension plan settlement gains over the average of such gains for the prior three-year period. The number of lump sum payments to employees leaving the Company in 1999 was 4.6 times the number on average during the prior three-year period.

Exhibit ASP-6
Ameritech Pension Plans Lump Sum Settlements and Settlement Gains
For the Four Years Ended December 31, 1999
(Dollars in Thousands)

	1999	1998	1997	1996
Lump Sum Payments from Pension Plans				
• AMPP	$462,900	$163,461	$144,879	$150,017
• APP	601,000	108,814	66,065	49,489
Related Settlement Gains				
• AMPP	305,900	0	0	0
• APP	260,800	0	0	0
Number of Employees Leaving the Company Electing Lump Sum Payments				
• AMPP	2,258	475	449	517
• APP	3,356	900	762	554
Number of Lump Sum Payments to Employees whose Terminations are Considered by the Company to be Merger Related				
• AMPP	39	0	0	0
• APP	0			

Source: Document Request JDH-13

6. The Company is correct in its assertion that settlement gains recorded in 1999 represent an accelerated recognition of gains that occurred in previous periods but were deferred in accordance with FAS 87 accounting requirements. However, the recognition of the gains

resulting in credits to expense for accounting purposes in 1999 is in part attributable to the merger.

- Based upon the Company's representation of the number of terminations that are merger related, and direct apportionment of the settlement gain, $6.8 million of the gain is clearly attributable to merger related terminations as shown in Exhibit ASP-7 below.

Exhibit ASP-7
Merger Related Settlement Gains
(Dollars in Thousands)

	AMPP
(1) Total FAS 88 net Gain	$305,858
(2) Total Lump Sum Distributions	462,900
(3) Merger Related Lump Sum Distributions	10,300
(4) FAS 88 Gain attributable to the Merger {(1)x[(3)/(2)]}	$ 6,806

Source: SBC Analysis of Settlement Gains (Document Request DPV-12.1). Calculation based on employees whose 1999 termination the Company says is merger related.

- FAS 88 requires immediate recognition of certain previously deferred amounts when certain events occur and prescribes the method for determining the amount to be *recognized in earnings* when a pension obligation is settled. It is not reasonable for the Company to ignore generally accepted accounting principles in its determination of merger related savings.

- Further, the Merger Order specifically states that "...the term 'savings' refers to an actual reduction in costs or expenses." (Order at 147)

7. Although the SBC and Ameritech pension plans are not scheduled for integration until 2003, Ameritech adopted amendments to the APP and AMPP as of July 1, 1999 to conform certain actuarial assumptions with those of SBC. One of these changes had a significant impact on pension expense.

   - The FAS 87 discount rate was changed from 6.75 percent to 7 percent at July 1, 1999.

   - The expense recorded for the year ended December 31, 1999 was based on a 6.75 percent discount rate for the first half of the fiscal year, and a 7 percent discount rate for the remainder of the year.

   - A higher discount rate results in lower liabilities and expense.

   - Pension expense for the year was reduced by approximately $46.8 million due to this change as shown in Exhibit ASP-8 on the page that follows:

Exhibit APS-8
Ameritech Pension Plans Impact due to the Change in Discount Rate
Year Ended December 31, 1999
(Dollars in Thousands)

	AMPP	APP	Total
(1) Actual annual expense for the period 1/1/99-12/31/99	$302,910	$117,098	$420,008
(2) Expense for the period 1/1/99–7/1/99 using a discount rate of 6.75%	135,916	50,676	186,592
(3) Estimated expense for the period 1/1/99-12/31/99 assuming a discount rate of 6.75% throughout the entire fiscal year [2 x (2)]	271,832	101,352	373,184
(4) Estimated change in expense for the period 1/1/99-12/31/99 due to change in discount rate [(1)-(3)]	$31,078	$15,746	$46,824

Source: USI Analysis.

8. Although there is a significant decrease in Ameritech Illinois operating expenses in the 1st Quarter 2000 when compared to the 1st Quarter 1999, our analysis identified only the pension expense reduction as a potential merger related savings not reported by the merger teams or that had not come to our attention through other procedures in the audit.

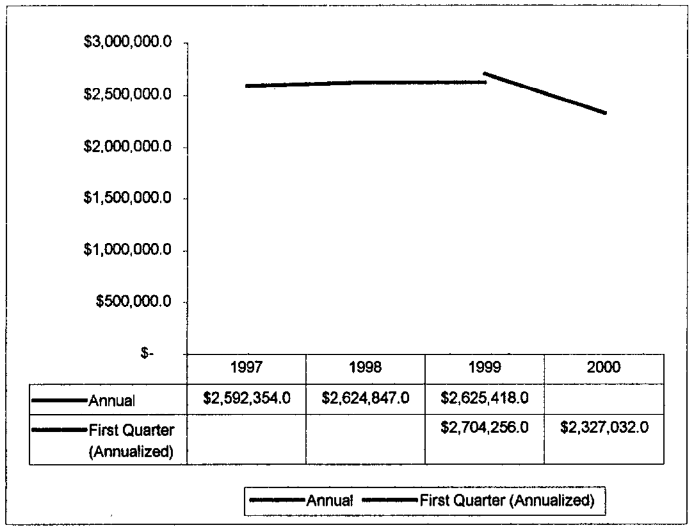
   - Ameritech Illinois operating expenses were fairly constant from 1997 to 1999, but decreased following the merger. Exhibit ASP-9 shows the trend in AI's operating expenses on an annualized basis.

   - From this comparison, it is difficult to identify any potential additional merger savings possibilities because merger savings are small in comparison to the base and are difficult to isolate from changes in expense levels attributable to many other operational factors.

9. The decrease in operating expenses exceeds the amount of savings reported in the Merger Tracking database.

   - As shown in Exhibit ASP-9 Ameritech Illinois' operating expenses decreased $94 million (14%) between the 1st Quarter 1999 and 1st Quarter 2000. The Merger Tracking database indicates net positive savings of (redacted) for the first quarter 2000 for all of SBC.

Exhibit ASP-9
Total AI Operating Expenses
(Dollars in Thousands)



	1997	1998	1999	2000
Annual	$2,592,354.0	$2,624,847.0	$2,625,418.0	
First Quarter (Annualized)			$2,704,256.0	$2,327,032.0

Source: BWG Analysis, AI monthly ARMIS 43-03-type reports (Document Requests WJD-1.9 and WJD-2.5) and AI 43-03 reports from the FCC website.

- At this time, it is not possible to determine whether specific account variances are related to specific merger initiatives. There is no direct link between the merger costs and savings information tracked in the Oracle database, and USOA accounts.

- As discussed in the MIT chapter, SBC does not track merger costs and savings by USOA account. The Company allocates merger team cost and savings information to USOA accounts annually, and will not perform this analysis until early 2001.

- Exhibit ASP-10 lists the USOA accounts with quarter to quarter variances over $1.0 million or 10 percent, the Company's explanation of the primary cause of the variance, and BWG's assessment of whether the variance is merger related.

- As shown in Exhibit ASP-10, many of the decreases in operating expenses are related to decreases in personnel-related costs and decreases in Parent company and ASI service billing. BWG believes that these decreases are primarily merger related; however, the Company has not confirmed this.

Exhibit ASP-10
Comparison of AI First Quarter 1999 and First Quarter 2000 Operating Expenses
Expense Accounts with Significant Variances
(Dollars in Thousands)

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Quantified Results of Investigation

1. The Company has not yet determined the amount of post-merger depreciation expense savings. BWG estimates annual depreciation expense savings of approximately (redacted) before the Illinois allocation. (Refers to Conclusion No. 1)

2. In connection with its pre-merger due diligence, the Company identified approximately (redacted) in potential savings relating to Illinois state income tax expense. This amount is not included in savings being reported by the merger teams and should be considered merger related savings when realized. (Refers to Conclusion No. 2)

3. Merger related pension plan settlement gains are at least \$6.8 million in 1999, and may be as much larger if employees who terminated their service in anticipation of the merger are considered in the calculation. (Refers to Conclusions No. 5 and 6)

4. Merger related changes in actuarial assumptions resulted in a \$46.8 million reduction in Ameritech pension expense for the year ended December 31, 1999. (Refers to Conclusion No. 7)

Recommendations for the Company

None.

Policy Issues for the Commission

1. Determine whether or not pension plan settlement gains and expense reductions attributable to changes in actuarial assumptions to conform the SBC and Ameritech pension plans are merger-related and develop appropriate guidelines and reporting requirements for the Company to follow. (Refers to Conclusions No. 6 and 7)

2. Consider whether or not an imputed reduction in interest expense relating to revenue enhancement initiatives within the regulated telephone operating companies is a merger related expense savings to be shared with ratepayers in Illinois. (Refers to Conclusion No. 3)

3. The Commission should consider whether or not an imputed savings in the cost of capital related to improved cash flow from reduced capital expenditures constitutes savings to be shared with ratepayers in Illinois. (Refers to Conclusion No. 3)

Future Audit Issues

1. After the Company files its Year 2000 Merger Cost and Savings Report, review USOA accounts used to record depreciation expense to determine whether or not costs and savings are included. Obtain information from the Company needed to compare Ameritech Illinois pre and post-merger depreciation rates and amounts as a

2. percent of plant in service to determine whether adjustments to savings amounts reported by the Company are required. (Refers to Conclusion No. 1)

3. Determine the number of employees who left the Company in 1999 in anticipation of the merger and recompute merger related pension plan settlement gains. (Refers to Conclusion No. 5)